



Arizona Utility
Investors Association

3030 N. Central, Ste. 506
P.O. Box 34805
Phoenix, AZ 85067
Tel: (602)230-0428
Fax: (602)230-2738

RECEIVED
AZ. CORP. COMMISSION

JAN 25 8 51 AM '95

DOCUMENT
CONTROL

Arizona Corporation Commission

DOCKETED

JAN 25 1995

DOCKETED BY

gml

RE-000000-94-0165



0000065512

5

**POSITION PAPER
BY THE ARIZONA UTILITY INVESTORS ASSOCIATION
ON COMPETITION IN THE ELECTRIC UTILITY INDUSTRY**

January 1995

Introduction

At this writing, utility regulators and other government units in at least 30 states, including Arizona, are engaged in some type of inquiry into the phenomenon of competition in the electric utility industry. In various jurisdictions this issue may be referred to as deregulation, direct access or retail wheeling. Whatever the label, it boils down to a premise that the industry is moving toward a retail marketplace in which some or all users of electricity will be able to obtain access to competitive energy sources rather than being tied to the utility franchise in which they are located.

Many utility chief executives say that electric service is no longer a natural monopoly and that some degree of retail competition is inevitable. In fact, forms of competition already exist at the wholesale level and the direction of the Congress, in the National Energy Policy Act of 1992 (EPACT), and the Federal Energy Regulatory Commission (FERC) is toward a more competitive future.

The competition issue received unexpected impetus last April when the California Public Utility Commission (CPUC) announced its intention to transform California into an open market for retail electric service. According to the CPUC's announced timetable, this transformation would occur in stages until, in 2002, all consumers would be able to choose among competing sources of electric service.

It is unknown how the CPUC will resolve a host of complex legal and financial issues to arrive at a free market. However, the uncertainty created by the California commission's sudden policy declaration disturbed the financial markets, resulting in major losses for utility shareholders. Some industry analysts estimate that shareholders in California utilities have lost \$8 billion in equity since the CPUC announcement.

The electric industry is one of the most capital intensive industries in the world economy. It has been characterized by long planning cycles and financing mechanisms that repay capital investments slowly. Trillions of dollars are invested in the power production, transmission and distribution facilities of both public and privately owned utilities.

For regulated companies, the continuing value and profitability of their investments are tied tightly to the regulatory compacts that have existed for many years between the utilities and the regulatory agencies. The investor's understanding of the regulatory compact is that when a utility company makes a prudent financial commitment in order to serve its customers, the cost incurred will be recoverable in rates.

Both consumers and investors benefit from the regulatory compact. Consumers receive price protection and are assured service when they want it. Investors accept a limited return on their investment in exchange for reduced risk and a comparatively stable business environment.

The events in California raise the imminent prospect that these compacts could be abandoned or radically altered without a clear vision of the consequences to investors, customers and service areas.

While publicly owned utilities may not be governed by regulatory compacts, their financial health and access to financial markets is conditioned on similar factors, including a stable customer base and a predictable revenue stream. In addition, their rate structures are often required to support municipal services and infrastructure that are critical in their service areas.

Discussion

The Arizona Utility Investors Association (AUIA) is made up of thousands of individual investors in electric, gas and water utilities which are operating in Arizona. Our mission is to ensure fair treatment for utility investors and to help safeguard our members' investments.

AUIA is working to understand the probable benefits and risks in electric competition. We are intervenors in the Arizona Corporation Commission's current inquiry into competition in the electric industry.

AUIA is not opposed to the concept of competition in the electric industry. We support business competition as a benefit to both investors and consumers.

The infusion of competitive thinking into the industry has already been beneficial to the companies whose shareholders and bondholders we represent. For example, Arizona Public Service Company and Salt River Project have worked successfully in recent years to cut costs, achieve new efficiencies and prepare for competition. APS recently **reduced its rates** by some 2.2 percent, and SRP has pledged **not to raise rates before the year 2000**. These companies may be comparatively well positioned to withstand or capitalize on competition.

However, both utility investors and customers are at risk for any unintended consequences of deregulation. Therefore, efforts to change the regulatory compact should be undertaken carefully, based on a clear understanding of the gains and losses which will accrue to customers and investors.

Those who are most vocal in arguing for direct access and rapid deregulation are out to help themselves. Large industrial energy users want access to the cheapest sources of electricity they can find, and they also want to avoid utility system costs which aren't germane to their needs. A new breed of energy brokers and independent power producers (IPPs) is anxious to serve large users if they can have the freedom to roam through the utility grid system.

But what about everyone else? Are the power brokers and IPPs willing and able to extend the benefits of direct access to residential, small commercial, agricultural and rural customers? We doubt it.

If some utilities are picked clean of their largest customers (who are also the cheapest to serve), who will pay for the unused portion of the power plants, transmission and distribution facilities that are already in place? Will it be the company's remaining customers or its shareholders? The proponents of direct access have no responsibility for the consequences. They simply want cheaper power quickly.

Unresolved Issues

Many difficult issues need to be understood and resolved before the industry is propelled into a new world of competition. Here are a few of the issues which must be addressed:

- **Consumer Benefits:** It seems probable that the largest energy users could gain immediate benefits from bypassing the local utility franchise and acquiring direct access to cheaper sources of electricity. However, it is not at all clear how much further the benefits of competition will flow down the customer chain. Protections must be put in place so that captive customers do not have to absorb increasingly higher rates due to the departure of large customers who have more freedom to access other suppliers.
- **Stranded Investment:** Faced with a runoff of larger customers, some utility systems would find that they could not amortize their investments in power plants, transmission lines and distribution facilities under their existing rate structures. Losses could also extend to long term fuel and purchased power contracts and customer service facilities. Who would absorb these losses? The candidates include the utility's departing customers, its remaining customers and its investors. The issue of stranded investment must be addressed fairly because the cost of these systems was incurred for the benefit of all of the utility's customers.
- **Jurisdiction:** Jurisdictional conflicts are at the threshold of the debate over retail wheeling. The federal government and the states are both limited in what they can do to encourage or discourage competition.

In a competitive environment utilities will have to be paid for the use of their transmission and distribution facilities by users who are not (or are no longer) their customers. FERC -- not state regulators -- governs tariffs and access to most transmission lines because most of them serve interstate commerce. FERC may also develop rules for stranded investment, at least in the context of transmission charges. However, FERC's authority ends at the transmission line and state government has jurisdiction over the rest of the utility system. In Arizona, these issues are complicated further by the unique authority conferred on the Corporation Commission in the state constitution.

- **Service Obligations:** Unfettered competition could alter significantly the utility's traditional obligation to serve all customers. Electric companies could abandon services as customers leave and refuse to restore service or make it prohibitively expensive to return. And, if customers could shop anywhere for service, why shouldn't utilities be able to decide which customers they want to serve? Clearly, rules would be needed governing the mutual obligations of utility companies and their customers, including the terms under which customers can exit the system and return.

- **System Reliability:** When some of a utility's customers leave the fold and obtain power elsewhere, who is responsible for the reliability of their power supply? Who provides backup and at what cost? How do utilities maintain today's level of reliability for other customers on a shrinking revenue base? If they are driven by a least-cost objective, will tomorrow's power dispatchers feel the same responsibility for the safety and integrity of the system that they do today? And whose rules will they follow? Change which primarily serves the short term financial interests of one group of users could place at risk the world's most reliable electric transmission and distribution system.

- **Social Programs:** In a competitive environment in which a least-cost product is the goal, what happens to demand side management, conservation, the pursuit of renewable resources and special programs for the poor and the elderly? There would seem to be little incentive to maintain such programs in a completely market-driven industry.

- **Reciprocity:** Competition will raise questions of equity between jurisdictions and bring into focus a variety of external costs that are imposed on utilities such as taxes, environmental and aesthetic costs. For example, a utility's total tax burden, including income, ad valorem, excise, sales and regulatory taxes, may have a major impact on service costs in one jurisdiction and far less in another. In a competitive environment utilities will seek relief from unequal cost burdens.

- **Unbundled Service:** Today's utility customer pays one rate for a variety of utility services which are bundled together. These include power production, transmission, distribution and a variety of customer services such as meter reading, billing, billing inquiries, safety and conservation programs. In a competitive environment, some of these costs may have to be unbundled so that they can be apportioned to the customers who want or require them.

- **Wholesale Reform:** As an outgrowth of EPACT, the electric wholesale distribution system is going through a competitive evolution. APS, SRP and other utilities in the region have formed the Southwest Regional Transmission Association (SWRTA) in an effort to conduct wholesale transmission more efficiently and produce cost benefits for their customers. Some industry experts believe that if the wholesale system is structured to operate at peak efficiency, with unrestricted access, there will be few other benefits to be gained from retail wheeling. Their counsel is to rein in retail competition until reform at the wholesale level is completed.

Summary

In the long run, increased competition may be good for the electric utility industry, its investors and its customers. However, it should not be attempted until regulators have a clear picture of the benefits and risks and how they will be shared.

Both utility investors and consumers are at risk from unintended consequences of competition. Regulators are inclined to protect consumers before they throw a safety net to utility investors. But there is no assurance that the benefits of competition will ever reach down to residential and small commercial customers. And it is possible that these customers will have to shoulder costs that are currently being shared by all users.

If the regulatory compact is to be unstitched to make way for competition, it should be done very carefully to ensure an equitable distribution of the costs and risks. Otherwise, competition could lead to unfair price shifting and could become a means of transferring wealth from those who have invested capital in the utility infrastructure to those who want to use it for their own ends.

We urge the Arizona Corporation Commission and the Arizona Legislature to approach competition in the electric industry cautiously, based on a thorough examination of the many legal, financial and regulatory issues that lie beneath the concept of competition.

All stakeholders in the delivery of electric service should be involved in this examination, including the affected utilities, their investors and customers and those who make and carry out public policies affecting the infrastructure for economic growth and development in Arizona.

For More Information, Contact:

Bill Meek, President

TJ Taub, Managing Director

(602) 230-0428